

After Denial Comes Accommodation



By: John Rubino & Marcel Arsenault

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Back in June of 2006 I posted some [long excerpts](#) from an internal report produced by Colorado & Santa Fe Real Estate, a Denver firm owned by an entrepreneur named [Marcel Arsenault](#). After riding the long bull market in U.S. real estate to a considerable personal fortune, Marcel was doing something unusual for a real estate guy: He was selling out at what now appears to be the top. But not just selling out. He was so convinced that real estate was headed for a crash that he'd converted his company to a hedge fund that was shorting REITs and industrial commodities. So far so good. Over the past year his fund's short positions are up over 50%.

And now, while still shorting commercial real estate, which he thinks is about to follow housing into a deep recession, he's starting a vulture fund to buy up busted condo projects at pennies on the dollar. We spent an hour on the phone the other day going over Marcel's view of the world and of his company's future. Here's a slightly edited transcript. The headings are mine, the rest is Marcel:

On Selling Out

We sold most of our property near the top, but real estate values are falling and on the last few deals we had to cut our prices. I recently sold my Aurora Corporate Center for a couple million less than I paid a few years ago. In over 140 deals, it's the first money I ever lost on real estate (a tribute to how long the boom was!). In the past 20 years any idiot could have made money in real estate. We've sold over 4 million square feet, or about two-thirds of what we started with, in order to build a war chest of cash to buy distressed real estate later.

Buying Busted Condo Projects

We've formed a new real estate company, Condo Capital Solutions, and it's already getting attention: Bloomberg recently interviewed me for a TV program featuring Florida real estate. The number of "busted condo" projects is growing, but wholesale prices are not being marked to market yet by the sponsors (or the lenders taking projects back in foreclosure). In a market that's in freefall, like Florida, buyers and sellers are able to "write their own script" about where future housing prices will land. We bid on a partly-sold-out condo deal in Florida with a \$55 million loan balance and a \$44 million appraisal, but it was difficult to price in a falling market. The appraiser had to value it at "current market" even though prices for units being sold were in freefall. We offered \$29 million, which the seller doesn't want to accept because it's below appraisal. At this point most sellers of distressed condo projects can't hit the bid.

At a retail level [individual condos] buyers and sellers are meeting because buyers are less informed about where the market is trending. If you see something that's down 10%, it's a condo you really want,

and mortgage rates are low, you can rationalize it because you just moved from Philly and your old house was down in value too. "It's in a good school district, it's near your new job, the wife loves the neighborhood, and you're going to live there for another ten years", blah blah blah. So at a retail level, the buyers may be nervous but they're hitting the bid. Not so for commercial buyers of 200-300 condo unit projects. If you're a seller you say "well surely it's not going down any more because it's already down 20%." If you're the buyer and you know that historically prices fall 40%-60% over 3 years during Florida condo downturns, you're not going to bid with prices only down 20%. So there's a buyer-seller gap at the wholesale level. Banks taking projects back in foreclosure are currently in various states of denial. But after denial comes accommodation. We're waiting for that process to work its way through the system. In the meantime, it's dangerous to "catch a falling guillotine".

Commercial Real Estate (Retail, Office, Industrial)

The thing that's keeping commercial real estate afloat is that owners enjoyed a good economy for the last five years. Tenants are still paying rent, and until recently, expanding. But once the economy turns negative—I think we're probably in the beginning stages of a recession—then that fig leaf of "I've got income fundamentals working for me" goes away. By year end, it's a different world for commercial owners. After six years of writing mortgages at super peak values, in which commercial mortgage debt doubled nationwide, commercial mortgage lenders are suddenly realizing that they're highly exposed and are starting to tighten up. Once mortgage volumes start falling, lenders will tighten mortgage underwriting, triggering a feedback loop that produces a crescendo of falling values. Our proprietary liquidity index predicts a downtrend that reflects the past few years' logarithmic upturn, but in reverse.

Most commercial lenders and property owners don't agree, but commercial real estate is likely headed for a worse downturn than housing. After all, a subprime borrower living a house will typically do whatever she can to keep the house. The scoundrels I know in commercial real estate will send the keys back in a heartbeat. So once the downturn starts, commercial real estate will be "marked to market" brutally and efficiently. The only winner in will be the foreclosure and bankruptcy attorneys.

So why bid on property now?

We want to line up our operating and financial partners, and for that you have to have your infrastructure in place. We have to be out there talking to banks even if the banks don't see a serious drop in price coming. The best way to talk is to make the banks an offer. Right now the banks are unrealistic, but they know we have the financial capacity to buy. If they have our offer in their file and we stay in touch, someday our \$29 million offer is going to look reasonable. Meanwhile, there's always the chance that some boss comes from corporate and says "we have to get something off the books; I don't like \$29 million, but can these guys close by the end of the month?" And you get the call out of the blue saying "okay we'll take 29." So you need the staff, website, brochures and working partners on the ground in Florida. You've got to have your investors lined up. You have to be ready to perform once the sellers are ready to hit the bid.

When we started selling our commercial real estate, we sold some early, we sold some right at the peak and now we're selling a little late. We feathered out. Buying busted condo deals, we'll be feathering in over three or so years. We'll buy a few deals early, most of the deals at the bottom, and a few deals late.

What other advice?

Avoid the financials, particularly banks. They're just working through the first of three or four perfect storms that are coming. They're dealing with their subprime problems but they haven't set much aside for the coming consumer credit card and auto loan recession; they haven't set much aside for the coming wave of corporate loan defaults, nor have they prepared for a commercial real estate downturn. According to the FDIC, many banks' commercial real estate exposure is triple their capital. I wouldn't touch most commercial real estate loans made in 2005-2007 with a ten foot pole. They'll have to write a

lot of this off as the economy deleverages.

But right now, most of these loans still look okay to the banks and the bank examiners. If you're a regional bank and you've made a loan to a developer and he's building an office tower or retail center, as far as you know, he's healthy. But throw in a recession and a year from now that loan is in the bank's workout department.

The sovereign funds will come in and bail out a few of the bigger banks, but they're only investing a few percent of their capital. If Citibank comes back for a second round, sovereign funds are not going to be happy campers. Like Bank of America did 4 months ago with Countrywide, they got in early, and they got hammered. Just because banks and sovereign funds are huge beyond belief, doesn't mean they're smart. Otherwise Fannie and Freddie wouldn't be in trouble, and CEO's wouldn't be cashiered in droves.

This is a liquidity crisis. In a systemic deleveraging, assets plummet in value as lenders call in their loans and tighten lending standards. They'll suck up cash like a fire sucks up oxygen. Cash will move from being king to emperor.

By year-end many local homebuilders will be at death's door. A lot of hardworking, decent operators will need to be recapitalized. We're thinking of acquiring some of them. But now is too early. Home prices are only down 6%, and if they've got to fall 21% (as we projected in 2005).....well you get the picture. Don't catch a falling guillotine. Wait for the massive thud before you put your hands in there.

After the homebuilders, many banks will need investors. Particularly in places like Florida, Phoenix and Las Vegas, regional and local banks are going to end up critically undercapitalized. I've always enjoyed the banking industry (maybe because I've always been a massive borrower). Lately I'm considering putting together teams of hard nosed, tough, seasoned bankers. We'd go in and start accumulating distressed banks. But that can't be done until the financial deleveraging has worked through the system. That's probably two years away, and you want to be waiting like a vulture.

In the meantime, remember:

1. Cash is Emperor
2. Don't try to catch a falling guillotine

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